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COORDINATED ISSUE
PETROLEUM INDUSTRY
REPLACEMENT OF UNDERGROUND STORAGE TANKS
AT RETAIL GASOLINE STATIONS
UIL: 263.23-00

ISSUES:

1. Whether the costs incurred to: (a) remove and replace underground storage tanks (USTs) at retail gasoline stations; (b) clean up soil contaminated by releases from the tanks; and (c) install monitoring systems, wells or other equipment associated with groundwater cleanup are capital expenditures under §§ 263(a) and 263A of the Internal Revenue Code or are currently deductible expenses under § 162.

2. Whether the costs incurred to: (a) remove, clean and dispose of USTs at retail gasoline stations; (b) clean up soil and groundwater contaminated by releases from the tanks; and (c) install monitoring systems, wells or other equipment associated with groundwater cleanup are capital expenditures under §§ 263(a) and 263A or are currently deductible expenses under § 162, where the tanks will not be replaced with new tanks.

FACTS:

Companies in the petroleum industry market gasoline through company-owned retail locations and through branded independent marketers. The independent marketers may either own or lease the property. The petroleum companies and independent marketers will collectively be referred to as "the taxpayers."

The taxpayers are corporations or partnerships on the accrual method of accounting. The retail locations generally consist of a paved area used for automobile access to the pumps and parking areas, a building used to market gasoline or a convenience store used to market nonpetroleum items, a canopy covering the gasoline pumps and sometimes the building, and in some cases a car wash facility. The USTs are connected by piping to the pumps and are part of the machinery used in the immediate retail sales of gas. The pumps also are usually connected to a monitoring unit in the building that allows the sales clerk to monitor the gasoline sales.

In 1988, the Environmental Protection Agency (EPA) issued regulations addressing (1) technical standards for design, construction, installation, and operation of UST systems, (2) requirements that the states must meet in order to administer the federal UST regulatory program, and (3) financial responsibility requirements to ensure that UST owners are able to take corrective action in the event of a release from a tank system. In complying with the EPA regulations, taxpayers have incurred substantial costs in removing and replacing leaking USTs and in cleaning up the related contamination.

The basic steps involved in replacing USTs typically include removing the old tanks and installing the new tanks with leak detection systems. The removal of the old tanks includes removing the paving material covering the tanks, excavating a hole large enough to gain access to the old tanks, disconnecting any strapping and pipe connections to the old tanks, lifting the old tanks out of the hole, and properly cleaning and disposing of the old tanks. Installation of the new tanks typically includes placement of a liner or barrier in the excavated hole, placement of the new tanks, installation of one or more leak detection systems, installation of an overfill system, connection of the tank to the pipes leading to the pumps, backfilling of the hole, and replacement of the paving. If the tanks or pipes have leaked, a number of options are available to the taxpayers to evaluate and clean up the contamination. For example, the taxpayers may install monitoring wells to evaluate the contamination, excavate and dispose of the contaminated soil, and install a water filtration and treatment system.

Taxpayers typically claim deductions for the costs incurred to remediate the contamination resulting from leaking USTs. In addition, taxpayers may claim deductions for the removal, cleaning and disposal costs of old tanks and, in some cases, the installation and/or acquisition costs of the new tanks.

LAW:

The deductibility of the costs incurred in connection with the removal and/or replacement of component parts of assets, such as USTs, is determined under §§ 162 and 263. In general, § 162 provides a deduction for ordinary and necessary business expenses. Section 1.162-4 of the Income Tax Regulations allows taxpayers to deduct the costs of incidental repairs that neither materially add to the value of property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition. Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, are capitalized and depreciated.

Section 263 generally prohibits deductions for capital expenditures. Section 263(a)(1) provides that no deduction is allowed for any amounts paid out for new buildings or for permanent improvements or betterments made to increase the value of any property. Under § 263(a)(2), no deduction is allowed for amounts expended in restoring property or in making good the exhaustion thereof for which an allowance has been made in the form of a deduction for depreciation, amortization, or depletion. Section 1.263(a)-1(b) of the regulations provides that capital expenditures include amounts paid or incurred (1) to add to the value, or substantially prolong the useful life of property owned by the taxpayer, such as plant and equipment, or (2) to adapt property to a new or different use. Section 1.263(a)-2(a) provides that capital expenditures include the cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year.

Section 263A provides that taxpayers must capitalize the direct and indirect costs properly allocable to real or tangible personal property produced by the taxpayer. Section

263A(g)(1) provides that, for purposes of § 263A, the term "produce" includes construct, build, install, manufacture, develop, or improve.

Through provisions such as §§ 162(a), 263(a), and related sections, the Code generally endeavors to match expenses with the revenues of the taxable period to which the expenses are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes. See, e.g., *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84 (1992); *Commissioner v. Idaho Power Co*., 418 U.S. 1, 16 (1974). Moreover, as the Supreme Court specifically recognized, the "decisive distinctions [between capital and ordinary expenditures] are those of degree and not of kind," and a careful examination of the particular facts of each case is required. *Welch v. Helvering*, 290 U.S. 111, 114 (1993); *Deputy v. du Pont*, 308 U.S. 488, 496 (1940); see also *INDOPCO, Inc. v. Commissioner*, 503 U.S. at 87.

DISCUSSION:

Costs of Removal and Replacement of Tank

The costs of removing the old tanks, the costs of the new replacement tanks and the costs of installing the new replacement tanks must be capitalized under § 263(a). These costs are capital expenditures, rather than deductible repairs, because the new tanks are a replacement of a major component of the fuel distribution system (asset), and the asset as a whole has increased in value and life expectancy. Thus, a replacement consisting of new tanks is beyond the scope of the repair exception to capitalization provided by § 1.162-4.

Removal costs of the tanks include the costs incurred to remove any concrete or paving material, the costs of excavating soil to gain access to the old tanks, and the costs to lift the old tanks out of the hole. The Service ruled in Rev. Rul. 2000-7, 2000-1 C.B. 712 that the cost of removing an asset to replace it did not have to be capitalized under §§ 263(a) or 263A as part of the cost of the replacement asset. However, the Service cautioned that its analysis did not apply to the removal of a component of a depreciable asset, the costs of which were either deductible or capitalized based on whether replacement of the component was a repair or improvement.

The UST is a component of the fuel distribution system and not a separate asset for depreciation purposes. The tanks are connected by piping to the fuel pumps and are part of the machinery used in the immediate retail sales of gasoline. The tanks are not separate storage facilities within the meaning of § 1.48-1 because they are not used to store commodities for future use, but are tangible personal property within the meaning of § 1.48-1(c). See Revenue Ruling 74-602 and GCM 36020. The analysis in Rev. Rul. 2000-7 does not apply to the removal costs associated with the component tanks; the costs of which are either deductible or capitalizable based on whether replacement of the tanks constitutes a repair or improvement. See §§ 1.162-4 and 1.263-1(b).

When a major component or a substantial structural part of an asset is replaced and, as a result, the asset as a whole has increased in value, life expectancy, or use then the costs of the replacement must be capitalized. See, e.g., *Denver & Rio Grande Western R.R. Co. v. Commissioner*, 279 F.2d 368 (10th Cir. 1960) (costs to replace major portion of viaduct, including floor planks and stringers, were capital expenditures); *P. Dougherty Co. v. Commissioner*, 159 F2d 269 (4th Cir. 1946) (costs to replace entire stern section of barge with new materials were capital expenditures); *Vanalco, Inc. v. Commissioner*, T.C. Memo 1999-265 (costs to replace the cell lining, an essential and substantial component of the cell, were required to be capitalized); Rev. Rul. 2001-4, 2001-3 I.R.B. 295 (costs to replace all skin panels on belly of airplane fuselage, a substantial structural part of airframe, were required to be capitalized). The tank replacement costs are capitalized as they have increased the value and life expectancy on the fuel distribution system asset.

The costs of removing the old underground storage tanks in order to replace them with new tanks must also be capitalized. Where a taxpayer replaces a major component of a depreciable asset, and the replacement of such component constitutes a capital expenditure with respect to that asset, rather than repair or maintenance, then the costs incident to, or associated with such capital expenditure must also be capitalized. For example, in *Phillips & Easton Supply Co. v. Commissioner*, 20 T.C. 455 (1953), the taxpayer, a vendor for industrial supplies and equipment, replaced the three inch cement floor in its building with a five inch reinforced concrete floor. The court held that the expenses of removing the old floor and installing the new floor were capital expenditures because the old floor had worn out and the new floor was a replacement and an improvement. The court notes that the replacement was a substantial, structural work, and the new floor made the building more valuable for use in the taxpayer's business because it accommodated the storing, handling, and moving of heavy equipment and inventories. Thus, the costs to remove any concrete or paving material, the costs of excavating soil to gain access to the old tanks, and the costs to lift the old tanks out of the hole must be capitalized under § 263.

However, the costs of cleaning and disposing of the old tanks are deductible as business expenses under § 162. Taxpayers dispose of USTs in the ordinary course of their business. The costs of cleaning and disposing of the tank are not incident to the creation of a capital asset and do not themselves create or enhance a capital asset or create significant long-term benefits. Therefore, the costs of cleaning and disposing of the old USTs constitute business expenses deductible under § 162.

In addition, the costs incurred by a taxpayer to clean up soil or groundwater contaminated by releases from the USTs that occurred during the course of the taxpayer's business operations may be deducted as business expenses under § 162. Because these costs merely restore the soil and groundwater to their approximate condition before they were contaminated by releases from the taxpayer's USTs, they do not result in improvements that increase the value of the taxpayer's property. See Rev. Rul. 94-38, 1994-1 C.B. 35.

The tax treatment of these items is not affected by the removal or replacement of the USTs because these costs relate to a different asset, (i.e., the soil/real property, rather than the fuel distribution system). Therefore, these costs are not capitalized as part of a general plan of rehabilitation to the fuel distribution system. See *Moss v. Commissioner*, 831 F.2d 833, 840 (9th Cir. 1987).

Groundwater treatment facilities, such as wells, pipes, and pumps to extract, treat, and monitor groundwater, and other types of monitoring equipment generally have a useful life substantially beyond the taxable year in which they are constructed and/or installed. Therefore, the costs of their construction and installation are capital expenditures under §§ 263(a) and 1.263(a)-2(a). See Rev. Rul. 94-38, supra. Moreover, because the construction or installation of these facilities constitutes production within the meaning of § 263A(g)(1), the direct costs and a proper share of allocable indirect costs of constructing and installing these facilities must be capitalized under § 263A. The capitalized costs of the groundwater treatment facilities and other monitoring equipment may be depreciated pursuant to § 168.

Removal of Tanks Without Replacement

In some situations, a taxpayer may choose to remove leaking USTs, but not replace the USTs with new tanks. Under such circumstances, because the taxpayer is not replacing a major component of the fuel distribution system, neither the value nor the useful life of such asset increased. Accordingly, the costs of removing the USTs are not part of, or incurred incident to, a capital improvement of the taxpayer's property. In addition, in this situation, neither the removal, cleaning, nor disposal of the old USTs materially increases the value or prolongs the life of the fuel distribution system. Therefore, the costs of removing, cleaning, and disposing of the old USTs may be deducted under §162.

The tax treatment of the cleanup costs is not affected by whether the taxpayers replace the USTs. For example, a taxpayer may choose to remove but not replace the tanks at a site where it no longer conducts business operations. As discussed above, costs incurred by a taxpayer to remediate soil and groundwater contaminated by releases from its tanks during the course of its business operations are deductible as business expenses under §162 because they do not produce permanent improvements to the taxpayer's property. See Rev. Rul. 94-38, supra. This does not apply in cases where the costs are incurred to adapt the property to a new or different use.

Similarly, the tax treatment of the costs of installing monitoring systems, wells, or other types of equipment to remediate the contaminated area is not affected by the removal and/or replacement of the tanks. As discussed above, the direct costs and a proper share of allocable indirect costs of constructing and installing these facilities must be capitalized under § 263A, regardless of whether the tanks are replaced.

CONCLUSIONS:

1. (a) Costs incurred to remove and replace USTs are capital expenditures under § 263(a). The costs to be capitalized are provided by § 263A. These costs must be capitalized to the basis of the fuel distribution system asset and may be recovered over the appropriate recovery period determined under §168. However, costs incurred to clean and dispose of the old tanks may be deducted under §162.

   (b) Costs incurred to clean up the soil and groundwater are deductible as business expenses under § 162, where such costs are incurred by the taxpayer that contaminated the property.

   (c) Costs of installing monitoring systems, wells or other equipment associated with the remediation and cleanup of the contaminated area, including direct and allocable indirect costs under § 263A, must be capitalized to the basis of the equipment. These costs may be recovered over the appropriate period determined under § 168.

2. (a) Costs incurred to remove, clean and dispose of USTs and remediate the soil and groundwater, in cases where the tanks will not be replaced, are deductible under § 162, where the costs are incurred by the taxpayer that contaminated the property.

   (b) Costs of installing monitoring systems, wells or other capital assets associated with the remediation and cleanup of the contaminated areas, including direct and allocable indirect costs under § 263A, must be capitalized, regardless of whether the USTs are replaced. The costs may be recovered over the appropriate recovery period determined under § 168.